

# S Corporation Shareholder Stock Basis



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# S Corporation Shareholder Stock Basis

- How to compute stock basis;
- What constitutes valid shareholder debt, and
- The tax ramifications of an S corporation's repayment to the shareholder.

# Introduction

Two main reasons for electing S corporation status:

1. Avoid double taxation, and
2. Allow losses to pass through to its owners.

Congress placed limits on the amount of pass-through losses that a shareholder is allowed to claim.

# Shareholder Loss Limitations

The three shareholder loss limitations:

1. Stock & Debt Basis Limitations,
2. At Risk Limitations, and
3. Passive Activity Loss Limitations.

All three limitations must be met before the shareholder can claim a pass-through loss. These are shareholder limitations and not corporate limitations.

# Shareholder's Schedule K-1

The shareholder will receive a Schedule K-1 from the S corporation, the Schedule K-1 does **not** state –

- the amount of the loss or deduction items which can be claimed, or
- the amount of the non-dividend distribution which is taxable.

# Importance of Stock Basis

The shareholder needs to know the amount of his/her stock and debt basis when:

- S corporation allocates a loss and/or deduction item to the shareholder,
- S corporation makes a non-dividend distribution to the shareholder, or
- Shareholder disposes of stock.

# Responsibility to Track Basis

- It is the shareholder's responsibility to track and calculate individual stock and debt basis.
- The requirement to keep adequate records is contained in Treas. Reg. §1.6001-1(a).

# Initial Stock Basis

As with the basis of any asset, we generally start with its cost.

- Stock purchase – cost
- Acquired by asset contribution to corporation (IRC §351) – carryover basis.
- Gifts – donor basis of gifts
- Inheritance – FMV at date of death

The initial corporate stock basis would be the same for a C corporation and an S corporation.



# S Corporation Stock Basis

- Adjusted basis of S corporation stock is **UNIQUE** in that it goes up and down each year based upon the corporation's pass-through items.
- Stock basis is determined at the end of the corporate year; there are special rules when a shareholder sells or disposes of their stock mid-year.

# Increases to Stock Basis

Item	Sch. K-1
1. Ordinary Income	Box 1
2. Separately Stated Income Items	Boxes 2-10
3. Tax-Exempt Income	Boxes 16a&b
4. Excess Depletion over Property Basis	Box 15c

# Decreases to Stock Basis

Item	Sch. K-1
1. Ordinary Loss	Box 1
2. Separately Stated Loss and Deductions	Boxes 2-12d and 14l or 14m
3. Nondeductible Expenses	Box 16c
4. Non-Dividend Distributions	Box 16d
5. Depletion for Oil and Gas	Box 17r

## Non-Dividend vs. Dividend Distributions

The S corporation is responsible for telling the shareholder the amount of dividend and non-dividend distributions

- **Non-dividend distributions** are reflected on Schedule K-1, Box 16. They reduce stock (not debt) basis, but not below zero.
- **Dividend distributions** are reflected on Form 1099 and do not affect basis and only exist if the corporation has earnings and profits from a C corporation.

# Income Not Reported

Stock basis is not increased if a shareholder fails to report pass-through income.

Exception:

When the shareholder is not required to file.

# Losses Not Claimed

Basis is reduced by loss and deduction items even when:

- Shareholder fails to claim the loss (Barnes v. Comm’r, T.C. Memo. 2012-80),
- Shareholder receives no tax benefit from the loss, or
- Shareholder must defer the loss under the at-risk limitations or the passive activity limitations.

# Need for an Ordering Rule

- Allowable **loss and deduction items** are limited to stock and debt basis.
- Tax-free distributions are limited to stock basis.
- Since both distributions and losses reduce stock basis, there must be an **ordering rule** for the items that increase and decrease stock basis.

# Stock Basis Ordering Rules

Stock Basis will be adjusted in the following order:

1. Increased for income items and excess depletion
2. Decreased for non-dividend distributions
3. Decreased for non-deductible items
4. Decreased for items of loss and deduction



# Stock Basis Example

Mark, the sole shareholder of an S Corporation, has \$15,000 of stock basis on 1/1/2014. Mark received a 2014 K-1 reflecting the following:

- Box 1 (\$20,000) ordinary loss
- Box 9 \$4,000 IRC §1231 gain
- Box 12A \$5,000 cash charitable contribution
- Box 16C \$1,000 non-deductible expense (T&E)
- Box 16D \$12,000 non-dividend distribution

# Stock Basis Example (continued)

## Income & Non-Dividend Distributions

1/1/14 Stock Basis	15,000
Plus: IRC § 1231 Gain	4,000
Stock Basis before distributions	19,000
Less: Non-dividend distributions	(12,000)
Stock Basis before nondeductible expenses	7,000

# Stock Basis Example (continued)

## Nondeductible Expenses

Stock Basis before nondeductible expenses	7,000
Less: Nondeductible expense	(1,000)
Stock Basis before loss and deduction items	6,000

# Stock Basis Example (continued)

## Loss & Deduction Items

Stock Basis before loss & deduction items	6,000
Less: Ordinary loss (20,000 / 25,000 x 6,000)	(4,800)
Less: Charitable contributions ( 5,000 / 25,000 x 6,000)	(1,200)
12/31/2014 Stock Basis	0

# Stock Basis Example (continued)

## Suspended Losses

2014 Ordinary loss	(20,000)
Allowable loss	(4,800)
Suspended ordinary losses	(15,200)
2014 Charitable contributions	5,000
Allowable deduction	1,200
Suspended charitable contributions	3,800

# Suspended Losses

- Suspended loss and deduction items due to lack of stock and debt basis:
  - Retain their character, are carried over indefinitely or until all of the shareholder's stock is disposed of.
  - Treated as loss and deduction items incurred in the subsequent tax year.
  - Are lost when a shareholder disposes of his stock.

# Stock Basis Ordering Rule Election

Treas. Reg. § 1.1367-1(g)

If an election is made, it changes the normal ordering rules:

1. Increased for income items and excess depletion,
2. Decreased for non-dividend distributions,
3. Decreased for items of loss and deductions,
4. Decreased for nondeductible expenses.

This reverses the items (3) and (4) of the stock basis ordering rules.

# Debt Basis

- Losses and deductions which exceed a shareholder's stock basis are allowable to the extent of the shareholder's basis in loans. IRC § 1367(b)(2)(A).
- Debt basis is computed similarly to stock basis but there are some differences. Those differences are beyond the scope today's forum.



# Debt Basis (continued)

## Bona Fide Indebtedness

- Corporate debt with third parties does not give a shareholder debt basis.
- A loan guarantee or a co-made loan is not sufficient to allow the shareholder debt basis.
- A shareholder is only allowed debt basis to the extent he/she has personally lent money to the S corporation.
- There must be **bona fide** indebtedness between the shareholder and the corporation.

# Debt Basis (continued)

## Reduced Basis Debt

- Losses and deductions claimed against a shareholder's debt basis reduce the shareholder's basis in the debt.
- If an S corporation repays reduced basis debt to the shareholder, part or all of the repayment is taxable to the shareholder.

Example: Shareholder loans the corporation \$10,000. The shareholder has claimed losses in excess of stock basis of \$6,000.

# Debt Basis (continued)

## Reduced Basis Debt Example

Shareholder now has basis in his or her note of \$4,000.

If the corporation repays any of the \$10,000, when basis was reduced to \$4,000, it would result in 40% being a tax-free return of basis and 60% being a gain on loan repayment.

Therefore, if the corporation repaid \$1,000 of the \$10,000 loan, the shareholder would have a gain on loan repayment of \$600.

# Debt Basis (continued)

## Reduced Basis Debt Example

This is an extremely simplified example. It illustrates that if the corporation repays a reduced basis debt, part or all of the repayment will be taxable to the shareholder.

The example does not address:

- If the corporation has income for the year versus a loss;
- Whether there are multiple loans, or
- Whether there are formal notes or open account notes.

# Summary

## S Corporation Stock Basis:

- Needs to be established to determine if losses are allowable, if non-dividend distributions are taxable or to compute a gain or loss on disposition;
- Tracking and calculating stock and debt basis is the shareholder's responsibility;
- Generally starts with cost; and
- Goes up and down based upon pass-through items.

# Summary (continued)

S corporation stock basis is adjusted at year-end in the following order:

1. Increased for income items and excess depletion
2. Decreased for non-dividend distributions
3. Decreased for non-deductible items
4. Decreased for items of loss and deduction.

# Summary (continued)

- Losses and deductions which exceed a shareholder's stock basis are allowable to the extent of the shareholder's basis in loans.
- Losses and deduction in excess of stock and debt basis are carried over to future years

# Resources

[www.irs.gov](http://www.irs.gov)

Key word: S Corporations